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E. L. SORENSEN, JR.
Executive Director

March 10, 2000

Re: Change in Ownership – Limited Partnership;
Grandparent/Grandchild – Step Transaction Doctrine
Request No:

Dear Mr. :

This is in response to your letter of December 8, 1999, in which you requested our opinion on the application of change in ownership provisions to a series of transactions between parents and their children and grandchildren. For the reasons set forth below, we have concluded that the step transaction doctrine would only be applicable to defeat the statutory exclusions for transfers #3 through #6 since the grandchildren who are partners in the partnership do not qualify for exclusion under Revenue and Taxation section 63.1, subdivision (3)(A), and the Uncodified Statement of legislative intent has not been interpreted to apply to grandchildren.

Transactions at Issue

You describe the following series of transfers, #1 and 2 of which have already occurred and #3 through 6 are proposed in order to avoid reassessment of the real property:

1. Parents have formed a (Family) Limited Partnership (LP1), into which they transferred certain real property, maintaining the same percentages of ownership in the real estate as in the entity. (Excluded from change in ownership under Rev. & Tax. Code section 62, subdivision (a)(2).)
2. Parents then gifted up to 49% of their LP1 ownership interests “to their children and grandchildren.” (Excluded from change in ownership under section 64, subdivision (a).)
3. To avoid the prospect of LP1 ownership interests representing cumulatively more than 50% of the total LP1 interests transferring from “original co-owners” (the parents) resulting in a change in ownership under section 64, subdivision (d), the parents propose to dissolve LP1 and return the real property to the owners in the percentages of their LP1 ownership interests. (Excludable from change in ownership under section 62, subdivision (a)(2)?)

4. Property will then be owned 51% by parents and 49% by children and grandchildren. Parents then propose to gift deed 2% of the real property to their children, so that the parents would collectively own 49% and the children and grandchildren would collectively own 51%. (Excludable from change in ownership under section 63.1?)
5. The family then proposes to form a new LP (LP2) maintaining ownership in the same percentages as in the real estate. (Excludable from change in ownership under section 62, subdivision (a)(2)?)
6. Parents would then begin gifting shares in the new LP (LP 2) to their children/grandchildren. (Excludable from change in ownership under section 64, subdivision (a)?)

The net effect of transfers #3 through #6 would transfer ownership of the real property and control of LP1 from the parents to their children and grandchildren in LP2, thereby avoiding the section 64, subdivision (d) change in ownership of the LP1 real property which would occur on the subsequent gifting of more than 1% of parents' LP1 ownership interests to their children or grandchildren.

Analysis

You have requested our concurrence with your conclusion that each of the above described transfers #3 through #6 is excluded by statute from being deemed a "change in ownership" and the "step transaction doctrine" should not be applied to eliminate any of the exclusions.

The "step transaction doctrine" seeks to prevent transactions from gaining tax benefits though a series of transactions, which benefits would not be available if the transaction were undertaken in one step. It has been applied to property tax transfers when unnecessary steps are taken merely to circumvent the intent of the change in ownership statutes; in which case, the "substance of the transaction, rather than the form" will determine if a change in ownership has actually occurred. (*Shuwa Investment Corp. v. County of Los Angeles* (1991) 1 Cal.App.4th 1635. See also, LTA No. 92/69, October 14, 1992, enclosed.) If, rather than dissolving LP1 and distributing the real property to the partners, the parents transfer more than 50% of their LP1 ownership interests to their children and grandchildren, the property originally transferred to LP1 would change ownership under section 64, subdivision (d), and would be reassessed in its entirety. Normally, therefore, the step transaction doctrine would collapse the series of transfers and bring about the change in ownership that would occur if parents simply continue to gift their LP 1 ownership interests. However, because this series of transfers #3 through #6 involves transfers of real property between parents and their children, resort to the legislative intent of section 63.1 is necessary to determine whether the step transaction doctrine will be applicable.

In an uncoded portion of section 63.1, Section 2 of Chapter 48 of the Statutes of 1987, the Legislature specifically addressed the application of the step transaction doctrine to parent-child transfers. Section 2 states in pertinent part that:

"...it is the intent of the Legislature that the provisions of Section 63.1 of the Revenue and Taxation Code shall be liberally construed in order to carry out the intent of Proposition 58 on the November 4, 1986, general election ballot to exclude from change in ownership purchases or transfers between parents and their children described therein. Specifically, transfers of real property from a corporation, partnership, trust, or other legal entity to an eligible transferor or transferors, where the latter are the sole owner or owners of the entity or are the sole beneficial owner or owners of the property, **shall be fully recognized and shall not be ignored or given less than full recognition under a substance-over-form or step-transaction doctrine**, where the sole purpose of the transfer is to permit an immediate retransfer from an eligible transferor or transferors to an eligible transferee or transferees which qualifies for the exclusion from change in ownership provided by Section 63.1. Further, transfers of real property between eligible transferors and eligible transferees shall also be fully recognized when the transfers are immediately followed by a transfer from the eligible transferee or eligible transferees to a corporation, partnership, trust, or other legal entity **where the transferee or transferees are the sole owner or owners of the entity or are the sole beneficial owner or owners of the property**, if the transfer between eligible transferors and eligible transferees satisfies the requirements of Section 63.1. Except as provided herein, nothing in this section shall be construed as an expression of intent on the part of the Legislature disapproving in principle the appropriate application of the substance-over-form or step-transaction doctrine." (Emphasis added).

Despite the use of the "sole owner" language, Board staff has followed the legislative mandate to interpret section 63.1 liberally and has read Section 2 to prevent imposition of the step-transaction doctrine whenever excluded transfers are preceded by transfers from or followed by transfers to legal entities owned by **both** transferees and transferors, so long as the ultimate result of the transfer is protected under 63.1. (See Annotation No. 625.0193.) However, having been drafted in 1987, Section 2 does not specifically mention transfers between grandparents and their grandchildren since there was no grandparent/grandchild exclusion available at that time. (See Annotation No. 625.0151.) Reading the grandparent-grandchild exclusion into legislation that pre-dates its adoption would require the broadest possible interpretation of Section 2, that we are not prepared to make at this time.¹

Moreover, even if the Legislature's intention could be presumed to prohibit the application of the step transaction doctrine to qualifying grandparent/grandchild transfers, the parents of the grandchild-transferee must be deceased per Section 63.1(a)(3)(A). (See Annotation No. 625.0218, LTA No. 97/32.) Therefore, if the grandchildren who are partners in the LP1 are not eligible for exclusion under section 63.1, the step transaction doctrine would

¹ The most recent guidance we have issued on the subject of grand-parent/grandchild transfers and step transactions, LTA No. 98/23 (enclosed) indicates the strategy by which the parent-child exclusion can be used to transfer property from grandparent to parent, then from parent to grandchild. (See Page 8, of LTA No. 98/23.)

March 10, 2000

apply to invalidate the exclusions for transactions #3 through 6 -- especially since the purpose of the proposed transfers is to avoid section 64, subdivision (d) change in ownership.

Please be advised that the views expressed in this letter are only advisory in nature; they represent the analysis of the legal staff of the Board, based on present law and the facts set forth herein, and are not binding on any person or public entity. We recommend you contact the assessor in the county in which the real property is located to ascertain whether he or she agrees with our analysis and opinion regarding the application of Section 2.

Feel free to call me if you have any further questions on this issue.

Sincerely,

/s/ Susan Scott

Susan Scott
Tax Counsel

Attachments

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cc:

Mr. Richard Johnson, MIC:63
Mr. David Gau, MIC:64
Mr. Charles Knudsen, MIC:61
Ms. Jennifer Willis, MIC:70
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